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SUBJECT: MEXICAN ENERGY ROUNDTABLE: DECLINING OIL REVENUE
AND LIMITED REFORMS

REF: A. MEXICO 2577

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Sensitive but unclassified, entire text.

Summary

¶1. (SBU) According to studies completed by Cambridge Energy Research Associates (CERA), President Felipe Calderon will contend with a real drop in oil revenue from about USD 54 billion in 2006 to the USD 27 billion range in 2012 as a result of decreasing production, a likely fall in heavy crude prices, and declining Mexican crude quality. To address this fall and shore up the budget, CERA believes Calderon will likely be able to get Petroleos Mexicanos (Pemex) corporate governance reforms passed, but that more comprehensive changes may not be possible. PRD opposition to the Calderon presidency, especially on the energy agenda remains deep, and Calderon will act first on the political agenda which will require continued substantial oil revenue. He will also have to build a more workable coalition between the executive and the legislative branches than was in place during the Fox administration. More controversially, CERA discounts Calderon's need to convince the Mexican people of the need for energy reforms, but rather they suggest that Calderon focus his attention on the Congress where the National Action Party (PAN) maintains a plurality in both congressional chambers (Chamber of Deputies 41%, Senate 39.4%). That said, the PAN has a very weak mandate from the Mexican electorate which remains divided. CERA also believes that post election protest weakened Mexican institutions, threatening the chances for energy reform. End summary.

Setting

¶2. (SBU) Econoff attended the semi-annual Mexican energy roundtable presented by Cambridge Energy Research Associates in Mexico City November 16. Participants included representatives from the Mexican Secretariat of Energy (SENER), Pemex, the Federal Electricity Commission (CFE), as well as representatives of international firms active in the Mexican energy sector. At the session, participants discussed the outlook for the Mexican oil and gas sector over the next five years as well as how the incoming Calderon team would address energy policy issues.

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Declining Quality, Declining Price, and Increasing Costs
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¶3. (SBU) CERA produced a relatively positive forecast (i.e. slow decline) of overall Pemex production based on Pemex's current production outlook:

	CERA Forecast of Mexican Oil Production (thousand barrels per day)
2006	3,284
2007	3,190
2008	3,055
2009	3,051
2010	3,018
2011	2,940
2012	2,874

¶4. (SBU) The group agreed that as more production comes from Pemex's most promising short term prospect, the Ku-Maloob-Zaap (KMZ) complex, the overall quality of Mexican oil will decrease. Tests show that oil from the Baksha, Kayab, Zazil-Ha, and Numan oil fields which should make up 20 percent of the KMZ mix by 2012 should significantly lower the overall quality of Mexico's dominant product, the Maya blend, reducing the price of Mexican crude. CERA reported that even accepting relatively optimistic Pemex production estimates, combined quality and limited volume declines, will decrease GOM revenue by as much as percent by 2012.

MEXICO 00006783 002 OF 004

¶5. (SBU) In addition to the revenue decrease due to volume and quality declines, CERA's base case oil price forecast shows West Texas Intermediate (WTI) crude dropping from USD 61/Bbl this year to USD 45/Bbl by 2010. CERA economists note the drivers of the forecast include projected large new discoveries slated to come on line in Kazakhstan and Brazil by 2010. They also believe that the current oil price has been buoyed by a "fear factor" sQemming from current global instability. Without further political "shocks" to maintain elevated prices, the "fear factor" effect on world oil prices will reduce over time. Combining quality and price effects, CERA forecasts the Mexican Price:

	Mexican Crude Basket Price Forecast (Real 2005 $)	WTI Forecast (Real 2005 $)
2006	55.26	61.00
2007	48.73	52.00
2008	40.61	46.00
2009	38.17	44.00
2010	36.67	45.00
2011	35.66	
2012	33.57	

¶6. (SBU) CERA and the industry representatives present agreed that Pemex's financing, operating, and capital costs would rise. Worldwide, oilfield services and supplies have increased 15 to 25 percent in the last 12 months. In the Mexico specific case, 74 percent of Mexican production today has an extraction cost below USD 4/BBL. While extraction costs for new develoments should be equivalent, beginning in 2010-2012, a significant portion of the Mexican production mix (11%) should begin to come from Chicontepec, a much more difficult to produce onshore field with production costs near USD 14/Bbl. Total production costs will more than double

during this period. At the same time, capital costs (reserve development and infrastructure construction) will rise dramatically as Mexican oil becomes much harder to find and develop. CERA predicts that exploration and development spending will increase 3.5 times between 2005 and 2012.

¶7. (SBU) Combining the effects of volume price, and quantity declines, and taking into account operating cost hikes and then applying the current formula for Pemex extraction duties and other taxes, CERA estimates the GOM's real income from hydrocarbons will decline from about USD 54 billion in 2006 to approximately USD 27 billion in 2012, even taking into account relatively rosy Pemex production forecasts.

Legislative Reform Strategy

¶8. (SBU) To offset this difficult scenario, the Calderon administration will have to develop a strategy to reform the sector. The crux of that strategy will depend on how Calderon and his administration manage the Congress. To describe the political process, CERA analysts divided necessary decisions into three areas

(1) Ideology versus Pragmatism -- the Calderon team must decide how deep and market based reforms must be, taking into account they must win the at least tacit support of the Party of the Democratic Revolution (PRD) to avoid derailing reforms

(2) Institutionalization versus Politicization -- The Calderon team must decide whether to trust in formal legislative mechanisms or informal political relationships, and,

(3) Status Quo versus Liberalization -- Calderon must also decide how quickly reforms are to be introduced. His team must move slowly enough to build support, all the while keeping in mind the growing GOM oil revenue decline.

Ideology versus Pragmatism

¶9. (SBU) Street protests since the July election have

dwindled, but as evidenced by their behavior in the lead-up to his inauguration, PRD opposition to the Calderon presidency remains deep. The incoming administration's first instinct has been to be pragmatic as evidenced by the President elect and his advisors' statements during the transition (reftels). CERA believes Calderon's first moves will be to protect national security, promote state's interests, and help to ensure the rule of law. At the same time, they see a real need for Calderon to develop a more workable coalition between the executive and the legislative branches than were in place during the Fox administration.

¶10. (SBU) Somewhat more controversially, CERA believes that there is a "dichotomy between public opinion and real support," thus they discount Calderon's need to convince the Mexican people that energy reforms would be worthwhile, instead, they believe that the new President will focus attention on the Congress. On the positive side, Calderon's National Action Party (PAN) maintains a plurality in both congressional chambers (Chamber of Deputies 41%, Senate 39.4%) and will benefit from institutional support offered by the executive. Especially after the abortive protests by the PRD, the PAN's support is growing. The country's economy remains stable, and politically there is significant continuity with the outgoing Fox team. Still though, the PAN has a very weak mandate from the Mexican electorate which remains divided. Calderon opponents are mobilized with the fate of the energy sector one of the principal points of division. CERA believes that post election protest weakened

Mexican institutions, a view not shared by all participants. Congress itself remains fragmented, and energy reform must share the stage with an extensive political agenda.

¶11. (SBU) Looking to the past performance of the Energy Committee, CERA analysts searched for indications of how the upcoming 60th legislature would behave based on the performance of previous Mexican congresses. CERA analysts argued that Mexican politicians have recently become more focused on hydrocarbons. In the 58th Legislature (2000-2003) 50% of proposals dealt with electricity and 24% dealt with hydrocarbons. The situation reversed under the 59th Legislature (2003-2006) 54% of proposals dealt with hydrocarbons and 26% dealt with electricity. CERA suggested that the switch resulted from the belief that CFE and the electricity monopoly had been "taken care of" while the real focus should be oil and gas. In both the 58th and 59th legislature, the PRI proposed more amendments than the PRD, the PAN or the Executive neither of which was active introducing energy legislation. The 58th legislature's Energy Committee within the Chamber of Deputies introduced 63 proposals while the 59th legislature introduced 97. Nevertheless, only 10 proposals passed (including fiscal reform for Pemex and a cogeneration package) The Chamber of Deputies, the analysts suggested, was a legislation filter, bringing only those bills forward that would justify passage. Despite the PRI's majority almost of the successful proposals came from the PAN.

¶12. (SBU) Earlier activity in the Congress also indicates that despite their function as a legislative filter, liberalization was unpopular. Only 5% of proposals dealt with the issue. Furthermore, in the 58th and 59th legislature, 33 percent and 47 percent of proposals were meant to strengthen institutions (CRE, SENER, Pemex, etc.). From this, CERA analysts that the PAN sought to strengthen the institutional basis for reform (Pemex fiscal reform). Nevertheless, they avoided direct political confrontations with the opposition and radical factions (PRD) by avoiding the liberalization issue. Questions remain as to how willing the PAN will be to approach the reform issue in the 60th congress.

Institutionalization versus Politicization

¶13. (SBU) The group also discussed whether Calderon would depend more on informal channels of communication between parties to achieve portions of his agenda, a strategy used by former President Carlos Salinas, or would he depend more on formal lines of communication between the legislative and executive that President Fox tried to use. While Fox depended on his cabinet secretaries to manage the Congress, CERA analysts noted that on energy, the administration failed

to provide the political support to the energy secretariat to complete meaningful legislation -- electing to focus on maintaining short term Pemex revenues high to boost government income. Even the most recent legislative proposal to reform Pemex corporate governance, with relatively broad acceptance across the political spectrum, failed to receive real support in congress from the Fox administration. The Secretariat of Energy (SENER) is traditionally weak; hence Fox's dependence on formal mechanisms combined with SENER's weakness in formal networking made it much more likely that reform legislation would fail in the previous congress.

Status Quo vs. Liberalization

¶14. (SBU) CERA believes that in the relative short term (3 months) Calderon will be able to "Address the main political

obstacles to energy sector restructuring" and "confront urgent needs." On the energy side, CERA believes that most legislative action would be geared to changing energy subsidy rules to better favor the poor. In the medium term (1 year) CERA suggested that Calderon will "Create an appropriate political environment for stimulating stable, legislative policy change in the sector." Internal lobbying for reform would be possible but would largely depend on how reform responsibilities would be distributed in the new cabinet. In the long term (3 years) CERA suggested that Calderon will "consolidate a coherent integrated energy reform." They believed that partial reforms such as diluting the representation of unions on the Pemex board would be possible, but a comprehensive reform was less likely. Going forward, the observers felt the PAN would seek to take advantage of the "new players" (i.e. the departure of 'old guard' such as the obstructionist PRI Senator Bartlett). CERA believed that the PRI role would be the most important for the PAN strategic interests.

Comment

¶15. (SBU) Of all Mexican energy prognosticators, CERA's current production forecast for Mexico is the most rosy, nonetheless, their price forecast suggests an almost 50% drop in Mexican government oil revenues over the next six years. CERA and most other participants in the session agreed that if any energy reforms that do pass, they would be slow in coming and would likely not be sufficient to stem Mexico's revenue slide. The balance between managing the energy sector to maximize current GOM revenues and ensuring future energy security through increased investment and liberalization will remain a difficult challenge.

¶16. (SBU) Some analysts believe that the Calderon team has already signaled it will behave as previous administrations and "take the money now." At the same time, new Finance Secretary Carstens said publicly on December 5 that Mexico

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should expect a fiscal reform proposal in 2007 given the GOM's need to increase revenues and allow Pemex to make significant investments over the next few years to maintain its export platform. This approach signals that the new GOM is aware that unless remedied, the costs of declining revenue and production will come due for Calderon by the middle of his term.

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